Office of Chief Counsel
Internal Revenue Service

memorandum

CC:WR:[redacted]:[redacted]:TL-N-6274-99
[redacted]

date: SEP 13 2000

to: [redacted], Territory Manager, Natural Resources
[redacted]
Attn: [redacted], Case Manager

from: District Counsel, [redacted], [redacted]

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subject: **Request For Advice**

Taxpayer: [redacted]
Attn. [redacted]

Taxpayer EIN: [redacted]

Representative: [redacted]

Disclosure: The name of the taxpayer and tax return information are disclosed in this memorandum.

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DISCLOSURE STATEMENT

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ISSUE

Whether the taxpayer is entitled to claim investment tax credit under the transition rules set forth in the Tax Reform Act of 1986 on properties placed in service after [redacted] by aggregating them with properties which were placed in service, under the taxpayer's depreciation practice, prior to [redacted], and treating the aggregated properties as a single property for transition relief purposes.

LIMITATIONS

The issue presented addresses whether the methodology used by the taxpayer to claim additional investment tax credits is conceptually flawed as a matter of law. The facts presented outline the general approach that was taken by the taxpayer in computing its claim for additional investment tax credit but they do not identify the types of properties or how specific properties were treated. Accordingly, this memorandum only addresses the validity of the methodology used and does not deal with the treatment of any specific property.

FACTS

Background

[redacted] ([redacted]) is a holding company which files a consolidated income tax return. [redacted] ([redacted]) is a first tier subsidiary of [redacted] and accounts for approximately [redacted]% of the revenues and assets of [redacted]. [redacted] owns [redacted]% of the outstanding shares of common stock of [redacted]. The issue in this case relates solely to [redacted].

[redacted]

[redacted]

In the mid-[redacted]s, [redacted] purchased [redacted], which at the time was [redacted] savings and loan in [redacted]. [redacted] also had operations in [redacted]. Shortly thereafter real estate values plummeted and, ultimately, the investment in [redacted] became worthless. In addition, [redacted] was required to make payments of about $[redacted] to the Office of Thrift Supervision and the Resolution Trust Corporation in consideration for being released from certain regulatory capital obligations. As a result, [redacted] incurred large consolidated net operating and capital losses. The net operating losses eliminated all of [redacted]'s regular income tax liabilities from the mid-[redacted]s through [redacted]. (All of those years were examined by the Service.)

In addition to the losses, a total of $[redacted] of investment tax credits were claimed on the original returns filed during the years [redacted] through [redacted].

In [redacted], the remaining net operating losses which resulted from the [redacted] transaction were utilized. [redacted] had ordinary taxable income of about $[redacted] after reduction for the remaining losses. Accordingly, [redacted]'s income tax liability, prior to the application of any available credits, was about $[redacted]. [redacted] was entitled to various credits, including ITC carryovers, totaling about $[redacted]. Thus, [redacted] had an income tax liability of approximately $[redacted]. Further, for years after [redacted], [redacted] no longer had any available carryover credits and was subject to ordinary income tax at the maximum corporate rate.

The accounting firm of [redacted], has audited [redacted]'s financial statements for a number of years. In [redacted], [redacted] group proposed to review [redacted]'s ITC generated by [redacted] to determine whether the full allowable ITC had been claimed on its returns. During the summer of [redacted], [redacted] reviewed the amount of ITC available and claimed for the years [redacted] through [redacted]. Based on this review, [redacted] determined that qualifying property in the amount of about $[redacted] had not been included in the ITC computations for those years. As a result, [redacted] concluded additional ITC in the amount of $[redacted] was available in the year [redacted].

An informal claim for the additional ITC was filed on [redacted]. [redacted] then executed a power of attorney in favor of [redacted] limited to the additionally claimed ITC. At the request of [redacted], the Service has been directed to conduct their examination of the ITC claim directly with [redacted].

In support of the ITC claim, [redacted] provided the Service with [redacted] notebooks containing their findings. The first [redacted] notebooks included administrative and general matters relevant to all parts of the claim. The remaining [redacted] notebooks each pertained to a specific "project" identified by [redacted].

After the Service had examined the evidence presented by [redacted], the parties agreed to correct certain duplications, computational mistakes, misclassifications, and other errors. Further, [redacted] conceded that ITC claimed on "Emergency Spare Parts" was not valid. As a result, the revised claim is for additional ITC in the amount of $[redacted], based on property with a basis of $[redacted].

[redacted] Fixed Asset Accounting

[redacted] has an annual capital budget of approximately $[redacted] million and an extensive authorization and monitoring system. Capital budget requests are prepared during the summer by each of [redacted] operating divisions. The principal divisions are [redacted], and customer service.

Each budget proposal is supported by a document either referred to as a "Project Initiation Proposal" or "Proposed [Name of Division] Budget Item." The documents state the need for the project, provides construction engineering data, estimated costs, and a timetable for completion. The management of each division reviews the requests and then prioritizes the projects and forwards them to corporate senior management for authorization. Corporate senior management prepares a formal capital budget for approval of the board of directors.

The vast majority of projects at issue are large constructions of [redacted] property. Although some portions of the construction may be completed by subcontractors, the projects are planned and supervised by [redacted] engineers. As would be expected, the projects rarely proceed as planned due to such factors as unanticipated construction difficulties, cost overruns, and changes in the assumptions underlying the need for the project. [redacted] engineers noted that the reason for most changes to planned projects is changes in the needs of the overall system requiring application of resources in other areas. The engineers describe the system as a work-in-progress.

After a project has been approved, the supervising engineer prepares "work orders" (interchangeably referred to as work authorizations) to begin the construction on the project. The work order (WO) specifies the work to be performed, projects an estimated cost, projects the number of man hours required, and projects the beginning and completion dates. Each WO is assigned a unique number and, in general, is reviewed/approved by a concurring engineer, the user and a budget officer.

The progress of a project is monitored by [redacted] through the use of Variance Analysis reports. [redacted] also prepares a "Closed Work Orders Dropped From Detail and WOCS Files" report which tracks the progress on all WOs and includes the "in-service date." On the date that the property constructed under a WO is placed in service, the accumulated costs are transferred from the Construction Work In Process account in the general ledger to a Fixed Asset account. Depreciation then commences for both book and tax purposes.

Under this accounting system, the completion of a WO constitutes (1) the existence of a property for depreciation and ITC purposes and (2) the placing of the property into service. The property was depreciated and, if the property was qualifying section 38 property, ITC was claimed. The ITC transition rules were also applied under this system.

As noted above, [redacted] reviewed all of the WOs placed in service during the years [redacted] through [redacted]. [redacted] determined that the work completed under a WO did not necessarily constitute a single property. [redacted] utilized a much broader definition of property. Accordingly, properties which did not qualify for ITC under the transition rules under [redacted] accounting system qualified under [redacted]'s definition of property.

STATUTE OF LIMITATIONS

As a preliminary matter, it should be noted that the statute of limitations on assessment has not expired even though the claims are for additional ITC which was generated in the years [redacted] through [redacted]. The statute of limitations for [redacted] has been extended, and is currently open, by execution of Form 872. The net operating losses incurred by [redacted] due to the [redacted] transaction caused the benefit of any ITC to be carried over until [redacted]. ITC on qualified section 38 property need not have been claimed on an income tax return, or in a timely claim for refund for the year the property was placed in service, before the credit can be carried over under section 46(b) to an open year. *See* Rev. Rul. 82-49. Accordingly, [redacted] can carry over the ITC generated in the years [redacted] through [redacted] to the year [redacted].

PROPOSED POSITION AND POSITION OF REVENUE AGENT

Section 38 provides for a general business credit against tax that includes the investment tax credit determined under section 46(a). Section 38(a) further provides that the general business credit is equal to the sum of the business credit carryforwards, the amount of the current year business credit, and the business credit carrybacks, in that order.

Section 46(a) provides, in part, that the amount of the investment tax credit is a percentage of the "qualified investment." Section 46(c)(1)(A) provides that the term "qualified investment" means the applicable percentage of the basis of each new section 38 property (as defined in section 48(b)) placed in service by the taxpayer during the year[1].

Treas. Reg. § 1.46-3(d)(1) provides, in part, that for purposes of the credit allowed by section 38, property shall be considered placed in service in the earlier of the following taxable years:

(i) The taxable year in which, under the taxpayer's depreciation practice, the period for depreciation with respect to such property begins; or

(ii) The taxable year in which the property is placed in a condition or state of readiness and availability for a specifically assigned function, whether in a trade or business, in the production of income, in a tax-exempt activity, or in a personal activity.

Treas. Reg. § 1.46-3(d)(4)(i) provides, in part, that "[t]he credit allowed by section 38 with respect to any property shall be allowed only for the first taxable year in which such property is placed in service by the taxpayer. The determination of whether property is section 38 property in the hands of the taxpayer shall be made with respect to such first taxable year. Thus, if a taxpayer places property in service in a taxable year and such property does not qualify as section 38 property (or only a portion of such property qualifies as section 38 property) in such year, no credit (or a credit only as to the portion which qualifies in such year) shall be allowed to the taxpayer with respect to such property notwithstanding that such property (or a greater portion of such property) qualifies as section 38 property in a subsequent taxable year."

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[1] For purposes of this memorandum, it is assumed that all properties at issue are qualifying section 38 properties.

In the current situation, under [redacted] depreciation practice, as soon as an individual WO was completed, the period for depreciation with respect to the property commenced. [redacted] does not necessarily require that the property constructed under the WO be placed in operation prior to depreciating the property. Under Treas. Reg. § 1.46-3(d)(1), a property is placed in service for purposes of claiming the investment tax credit in the year that depreciation with respect to the property begins.[2] And, under Treas. Reg. § 1.46-3(d)(4)(i), the credit is only available the first year a property is placed in service. As a result, the credit can only be claimed on property constructed under a WO, as a matter of law, in the year in which the WO is completed.

Even if it is assumed that [redacted]'s accumulation of WOs into a single property is accepted, ITC on that combined property could only be claimed in the year that the period for depreciation commenced on any part of the property. If any of the WOs are merely considered to be additions or improvements, then they would be treated as separate property. Additions or improvements to any property are treated as separate items for purposes of computing depreciation. See Rev. Proc. 87-57, 1987-2 C.B. 687. Similarly, additions or improvements would be treated as separate items in computing the ITC. Under Treas. Reg. § 1.46-3(d)(4)(i), the credit is only available the first year a property is placed in service, which is the date depreciation with respect to that property begins.

Nor could the aggregation of WOs be construed as a redetermination of the property's basis. Treas. Reg. §1.46-3(d)(4)(ii), provides that, "if, for the first taxable year in which property is placed in service by the taxpayer, the property qualifies as section 38 property but the basis of the property does not reflect its full cost for the reason that the total amount to be paid or incurred by the taxpayer for the property is indeterminate, a credit shall be allowed to the taxpayer for such first taxable year with respect to so much of the cost as is reflected in the basis of the property as of the close of such year, and an additional credit shall be allowed to the taxpayer for any subsequent taxable year with respect to the additional cost paid or incurred during such year and reflected in the basis of the property as of the close of such year. . . ."

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[2] Although Treas. Reg. § 1.46-3(d)(1), provides a property is placed in service for purposes of claiming the investment tax credit in the earlier year in which either (1) depreciation with respect to the property begins, or (2) the property is in a state of readiness; for purposes of this analysis, these dates are assumed to be the same based on the facts presented.

In this case, the basis of all the properties placed in service simply reflected the properties' actual cost. The amount to be incurred for the property placed in service was not indeterminate but, rather, was known. There were no contingencies or other unknowns which would impact the properties' cost or basis.

Other examples of the concept of basis redetermination that treat a purchase price adjustment to the cost of depreciable property as an adjustment to the basis of the depreciable property can be found in the Internal Revenue Code, Service publications, and court cases. Situations in which basis redeterminations derive from purchase price adjustments to the depreciable basis of property include the following:

(1) Rev. Proc. 87-57, 1987-2 C.B. 687 provides guidance in computing depreciation allowances for tangible property placed in service after December 31, 1986, and contains language in section 8.02 of the revenue procedure that implies that certain situations including the concept of basis redetermination (i.e., "any adjustments to the basis of the property for reasons other than (1) depreciation allowed or allowable or (2) an addition or an improvement to such property that is subject to depreciation as a separate item of property") would preclude taxpayers from using the optional depreciation tables in section 8 of the revenue procedure to compute annual depreciation allowances under section 168(a), as amended by section 201(a) of the Tax Reform Act of 1986.

(2) Section 168(d)(1)(B)(ii) of the Internal Revenue Code of 1954 provides that the Secretary shall by regulation provide for the method of determining the deduction allowable under section 168(a) for any taxable year and succeeding taxable years in which the basis is redetermined. (No final regulations have been issued under section 168(d)(1)(B)(ii) of the 1954 Code.)

(3) Inter-City Television Film Corp. v. Commissioner, 43 T.C. 270, 285 and 286 (1964), holds that a negotiated price reduction will affect amortizable cost basis of film rights in the year the price adjustment (i.e., price reduction) takes place and will influence the amount of amortization to be deducted in the year the price adjustment takes place and in subsequent years.

Thus, the concept of basis redetermination through purchase price adjustment for depreciation purposes is well recognized. The focus in these examples is that there is a contingent payout through anticipated adjustments (i.e. price adjustments based on gross profits) or where there are disputes resulting in a negotiated price adjustment. However, in this case, none of these factors are present.

Section 46(d)(1)(A) permits a taxpayer to elect, under section 46(d)(6), to increase the amount of its qualified investment for the tax year by including qualified progress expenditures with respect to "progress expenditure property," as defined in section 46(d)(2)(A). Section 46(d)(2)(A) of the Code defines the term "progress expenditure property" as any property that is being constructed by or for the taxpayer and that (i) has a normal construction period of 2 years or more, and (ii) it is reasonable to believe will be new section 38 property in the hands of the taxpayer when it is placed in service.

Section 46(d)(6) provides that a taxpayer must file an election to claim qualified progress expenditures. Treas. Reg. § 1.46-5(o)(2)provides that the election under section 46(d)(6) must be made on Form 3468 and filed with the original income tax return for the first taxable year ending after December 31, 1974 to which the election will apply. An election made before March 2, 1988, by filing a written statement (whether or not attached to the income tax return) will be considered valid. The election may not be made on an amended return filed after the time prescribed for filing the original return (including extensions) for that taxable year.

In the current case, there were no elections made and [redacted] has not asserted that [redacted] is entitled to claim any additional ITC as qualified progress expenditures.

Transition Rules

Section 49(a), which was added by section 211 of the Tax Reform Act of 1986 (Act), 1986-3 (Vol. 1) C.B. 83, states that, for purposes of determining the amount of the investment tax credit determined under section 46, the regular percentage (10 percent) does not apply to any property placed in service after December 31, 1985. Section 49(b) provides that section 49(a) does not apply to (1) "transition property" as defined in section 49(e), (2) in the case of any taxpayer who has made an election under section 46(d)(6), the portion of the adjusted basis of any qualified progress expenditures for periods before January 1, 1986, or (3) the portion of the adjusted basis of qualified timber property that is treated as section 38 property under section 48(a)(1)(F).

Section 49(e)(1) of the Code defines the term "transition property" as any property which was placed in service after

December 31, 1985, and to which the amendments made by section 201 of the Act (relating to the modification of the accelerated cost recovery system) generally do not apply. For purposes of the investment credit transition rules, section 49(e)(1)(B) substitutes "December 31, 1985" for "March 1, 1986" (the date generally applicable to the cost recovery transition rules). As so modified, the general transition rule for section 201 in section 203(b)(1) of the Act provides that the amendments made by section 201 of the Act shall not apply to:

> (A) any property that is constructed, reconstructed, or acquired by the taxpayer pursuant to a written contract that was binding on December 31, 1985,
>
> (B) property that is constructed or reconstructed by the taxpayer if
>
>> (i) the lesser of (I) $1,000,000 or (II) 5 percent of the cost of such property was incurred or committed by December 31, 1985, and
>> (ii) the construction or reconstruction of such property began by such date, or
>
> (C) an equipped building or plant facility if construction had commenced as of December 31, 1985, pursuant to a written specific plan and more than one-half of the cost of such equipped building or facility was incurred or committed by such date.

The foregoing transition relief is not available unless an additional placement in service requirement under section 203(b)(2) of the 1986 Act, as modified by section 49(e)(1)(C) of the Code, is satisfied. Section 203(b)(2) of the Act, as modified by section 49(e)(1)(C), imposes the further requirement that the above described property must be placed in service by the following dates:

Property with a Class Life of	Placed in Service Date
Less than 5 years	6-30-86
At Least 5 but less than 7 years	12-31-86
At least 7 but less than 20 years	12-31-88
20 years or more	12-31-90

Thus, in order to satisfy the general transition rules under sections 203 and 204 of the 1986 Act, property must satisfy both a specific effective date requirement and must be placed in service by a specified date depending on the property's class life.

In this case, it is [redacted]'s position that additional properties qualified as transition property under two of the exceptions set forth in section 203(b)(1) of the 1986 Act. Most of the additionally claimed ITC is for properties that allegedly qualify as transition property because the lesser of $1,000,000 or 5 percent of the cost of such property was incurred or committed by December 31, 1985, and the construction of such property began by such date. A few properties are also alleged to qualify under the plant facility rule. None of the properties at issue were claimed to have been constructed pursuant to a written contract that was binding on December 31, 1985.

It is apparent that the vast majority of the properties for which additional ITC is claimed would not qualify as transition property if they are considered as distinct properties on the basis used by [redacted] for depreciation. However, many of the properties constructed after December 31, 1985 would qualify as transition property if aggregated with the pre-1985 property into one single property. Under this scenario the combined properties generally have the lesser of $1,000,000 or 5 percent of the cost of such property incurred or committed by December 31, 1985, and the construction of such property began by such date.

In determining whether a property meets the requirements that the lesser of $1,000,000 or 5 percent of the cost of such property be incurred or committed by December 31, 1985, and the construction of such property begin by such date, it is necessary to define what constitutes a "property."

Neither the statutes nor the regulations define what is to be regarded as a single property for purposes of depreciation deductions and ITC. In <u>Hawaiian Independent Refinery, Inc. v. United States</u>, 82-1 U.S.T.C. 9183 (Ct. Cl. 1982) <u>aff'd</u>, 697 F.2d 1063 (9th Cir. 1983), <u>cert. denied</u>, 464 U.S. 816 (1983), the issue was whether two of the three major components of the oil refinery facility could be deemed separate properties with dates for beginning construction later than that of the project as a whole. The taxpayer argued that the refinery, marine terminal, and products pipelines were separate properties for purposes of applying the transition rule. In support of its conclusion that the three components should be treated as a single property, the court stated that if, as a practical matter, the facility could not function as designed without each of the components, it is reasonable to treat them as parts of a single property for purposes of the transition rule. The court noted that the refinery could not function without a system for receiving the crude oil and another system for removing and storing the completed products. The court further noted that all the components were placed in operation concurrently and it is reasonable to treat them as jointly having been begun when construction was begun on the first component.

In Public Service Co. v. United States, 431 F.2d 980 (10th Cir. 1970) the court considered whether component assets of an electric power plant could be treated as placed in service separately for investment credit purposes. The component assets included a turbine generator, a steam-generating unit, a cooling tower, a transformer, and a main power plant building. Id. at 982. The court found that the components could not be considered separately, because no one of them "would serve any useful purpose . . . but all of them properly fitted together by the contractor . . . constituted a complete unit which was operational and served the purpose intended by the [taxpayer]." Id. at 984. See also Siskiyou Communications, Inc. v. Commissioner, 60 T.C. Memo. 475 (1990).

In sum, courts agree that individual components will be considered as a single property for tax purposes when the component parts are functionally interdependent; that is, when each component is essential to the operation of the project as a whole and cannot be used separately to any effect. Conversely, if a project has component parts which can function as planned in a wholly independent manner, then each component could be considered a separate property.

In current situation, facts concerning the nature and function of any of the WOs were not presented. In order to determine whether the system of aggregation employed by [redacted] was reasonable and appropriate such facts are required. Therefore, it can not be determined whether the properties complied with the transition exception.

Finally, to qualify for transition relief, eligible property must be placed in service by the established deadlines as provided by section 203(b)(2) of the 1986 Act and I.R.C. § 49(e)(1)(C).

As noted above, pursuant to Treas. Reg. § 1.46-3(d)(1), a property is placed in service for purposes of claiming the investment tax credit in the year depreciation with respect to the property begins under the taxpayer's depreciation practice. And, under Treas. Reg. § 1.46-3(d)(4)(i), the credit is only available the first year a property is placed in service. Under [redacted] depreciation practice, depreciation begins in the year a WO is completed. Consequently, the credit can only be claimed on property constructed under a WO, as a matter of law, in the year in which the WO is completed because that is the year depreciation is commenced on the property. There are no provisions under which a single property can have more than one date when it is placed in service and depreciation begins. (Although there are provisions for qualified progress expenditures. I.R.C. § 46(d)(1)(A).)

If the claim were allowed as presented, [redacted] would depreciate and claim ITC for WOs completed prior to December 31, 1985 on the date the WO was completed. Each WO would be treated as a separate property. For purposes of the additionally claimed ITC, [redacted] would consider certain aggregations of WOs completed both before and after December 31, 1985 to be a single property. Such treatment is clearly inconsistent and unreasonable.

Because the properties are placed in service when a WO is completed, each WO should be treated as a separate property for ITC purposes. Accordingly, the method used to compute ITC by [redacted] on its original return appears to be appropriate. However, the facts provided were not sufficient to determine whether any specific property was placed in service by the transition rule deadlines.

POSITION OF TAXPAYER

As previously noted, [redacted] is not involved in the defense of the claim for additional ITC that was prepared by [redacted]. Thus, the position presented here is that of [redacted].

It is [redacted]'s position that the amount of construction executed under a WO is not necessarily relevant to how a single property is defined for ITC purposes. [redacted] proposes that a property be defined by reviewing the overall construction project. Using this reasoning, WOs which were not proposed or approved until sometime during the period of [redacted] through [redacted] are considered part of a property on which construction was begun prior to December 31, 1985.

[redacted] often refers to Steelcase, Inc. v. United States, 165 F.3d 28 (6th Cir. 1998), in support of its position. In Steelcase, the taxpayer began construction of an office building with a projected cost of $35 million, for which it sought transition relief. Subsequently, the design of the building was entirely replaced with that of a building with a projected cost of $100 million. The court held that even radical design changes do not prevent application of the binding contract rule. [redacted] contends that this case supports their broad definition of a property.

The result in Steelcase, Inc. does suggest that the definition of property may be broadly defined by the courts. However, in Steelcase, Inc., the court noted that the only substantial argument in favor of treating the two buildings as separate projects was the tax treatment originally sought for the expenditures. A portion of the costs of the first building were claimed as a deduction for abandoned property, indicating that the taxpayer had abandoned the building and begun a new one. The court accepted the taxpayer's contention that the deduction was in error and noted that a much larger percentage of the costs of the first building had been capitalized into the second building.

In contrast, in the present case, [redacted] has consistently treated each WO as a separate property under their depreciation and ITC practice. Thus, Steelcase, Inc. supports the position that each WO is a separate property.

[redacted] has not addressed the effect of the depreciation and ITC that have been claimed prior to December 31, 1985 on properties they propose to aggregate. Nor has [redacted] considered the impact of accepting their definitions of what constitutes a single property. If accepted, [redacted] would need to adjust the amounts and timing of their prior depreciation deduction and ITC claimed with respect to the properties.

We consider the statements of law expressed in this memorandum to be significant large case advice. Therefore, we request that you refrain from acting on this memorandum for ten (10) working days to allow the Assistant Chief Counsel (Field Service) an opportunity to comment. If you have any questions or require additional information, please contact Attorney [redacted] at [redacted]

[redacted]

Assistant District Counsel

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Office of Assistant Chief Counsel, Field Service
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